



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

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**UIL: 501.03-00; 511.00-00;
512.01-00; 514.07-00**

Legend:

<u>Date1</u>	=
<u>Year1</u>	=
<u>Year2</u>	=
<u>Year3</u>	=
<u>Year4</u>	=
<u>Year5</u>	=
<u>x1</u>	=
<u>x2</u>	=
<u>x3</u>	=
<u>x4</u>	=
<u>x5</u>	=
<u>x6</u>	=
<u>x7</u>	=
<u>x8</u>	=
<u>x9</u>	=
<u>x10</u>	=

Dear :

We have considered your ruling request dated June 24, 2009 concerning the applicability of the neighborhood land rule exception under section 514(b)(3) of the Internal Revenue Code ("Code" or "I.R.C.") to exempt land from being treated as debt-financed property under section 514 and income from that property to be subject to the unrelated business income tax ("UBIT") under sections 511 and 512 of the Code.

Facts:

You are a tax-exempt organization, classified as a church under sections 170(b)(1)(A)(i) and 501(c)(3) of the Code. You purchased the land through the use of debt financing in the neighborhood of your existing facility in order to build a larger facility. The land you purchased

comprises x1 acres of open, undeveloped land with the exception of two small buildings. The purchase price was \$ x2, with \$ x3 borrowed to buy the land. This debt was reduced to \$ x4 by the date of your ruling request. You filed your ruling request on June 24, 2009, at least 90 days prior to the end of the fifth year after the property acquisition date.

Site preparation, including public roads and utility infrastructure for development of your new facility began in early Year1. The two pre-existing buildings were demolished at that time. As of the date of your ruling request in 2009, you had begun construction of your new worship center, children's facility, and associated parking. As of the date of your ruling request, you had expended development costs of over \$ x5 to convert the land to tax-exempt use. These costs included civil engineering, facility design and construction documentation, entitlements from federal, state, and local jurisdictional agencies, grading, utilities, infrastructure, building piers, structural foundations, and parking facilities.

In the last quarter of Year2 you moved to your new larger campus location. It currently includes buildings that house a 4,000 seat worship center, children's building, and adult classrooms. The new facility, with roads and parking lots, covers x6 acres of the total x1-acre property. You currently plan additional improvements that will require another x7 acres. In addition, you have dedicated x8 acres to the city for roads, right of way, and a small park for public use. Thus, slightly more than half of the site will be developed. You have already listed your nearby former church building for sale.

You plan that the remainder of the acreage will be maintained in its undeveloped state as a part of the church campus. However, if the needs of the congregation require additional development of the site in the future, you represent that you will use the land only for exempt purposes. Currently, you have leased the undeveloped land at no cost for livestock grazing. The sole purpose of these leases is not the production of income, but rather is to exempt unimproved portions of the church campus from real property taxes. This is a common practice in the state because local property tax laws do not exempt from property taxes any portion of a church campus that has not been physically improved. You estimate that in Year3, property tax exemption due to the agricultural use of fallow land will save you \$ x9. You state that in leasing the undeveloped land at no cost, you are retaining the pastoral setting of the church campus while reducing the operating expenses of the church property.

You purchased the land with the subsurface rights, but with no plan to undertake exploration or production of any subsurface minerals. At the time you purchased the land, there was no indication that the subsurface estate had any value; the purchase price for the land was based upon the known value of the surface estate, and minimal, if any, value was attributed to the subsurface estate. However, some time later, an exploration company approached you to explore the subsurface of your land for potential mineral development. This company entered into a two-year lease with you for the right to explore the subsurface. You received one payment of \$ x10 in Year4 for that right. The lease expired in Year5 with no further payments. A commercially viable deposit was not identified and you have no plans to pursue any further development.

Requested Ruling:

1. That the church land will not be treated as debt-financed property under section 514(b) of the Code and income from rents or royalties from the land will not be unrelated business taxable income under section 512(b)(4) of the Code for 15 years from the date of land acquisition because the property qualifies for the (church) neighborhood land use exception provided for in section 514(b)(3)(E) of the Code.

Law:

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable, religious, scientific, or educational purposes provided no part of their net earnings inures to the benefit of any private shareholder or individual.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by an exempt organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(2) of the Code excludes from unrelated business taxable income, all royalties, whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

Sections 512(b)(4) and 514 of the Code generally impose income tax, notwithstanding the exception for royalties under section 512(b)(2) and rents under section 512(b)(3), on unrelated business taxable income from debt-financed property.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the function constituting the basis of its exemption.

Section 514(a)(1) of the Code provides that a portion of the income derived from, or on account of, each debt-financed property shall be included as an item of gross income derived from an unrelated trade or business.

Section 514(b)(1) of the Code defines "debt-financed property" to mean, with certain exceptions, any property which is held to produce income and with respect to which there is an "acquisition indebtedness" at any time during the taxable year.

Section 514(b)(2) of the Code states in a special rule for related uses, that exceptions to the definition of "debt-financed property" contained in sections 514(b)(1)(A), (C), and (D) apply to "the use of any property by an exempt organization which is related to an organization shall be treated as use by such organization."

Section 514(b)(3)(A) of the Code provides a special rule for neighborhood land. "If an organization acquires real property for the principal purpose of using the land (commencing within 10 years of the time of acquisition) for an exempt purpose and at the time of acquisition the property is in the neighborhood of other property owned by the organization which is used in such manner, the real property acquired for such future use shall not be treated as debt-financed property so long as the organization does not abandon its intent to so use the land within the 10-year period. The preceding sentence shall not apply for any period after the expiration of the 10-year period, and shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Secretary that it is reasonably certain that the land will be used in the described manner before the expiration of the 10-year period."

Section 514(b)(3)(C) of the Code provides that subparagraph (A):

- (i) shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only if (and so long as) the intended future use of the land for an exempt purpose requires that the structure be demolished or removed in order to use the land in such manner;
- (ii) shall not apply to structures erected on the land after the acquisition of the land; and
- (iii) shall not apply to property subject to a lease which is a business lease (as defined in this section immediately before the enactment of the Tax Reform Act of 1976).

Section 514(b)(3)(E) of the Code has a special rule for debt-financed property which extends the neighborhood land rule for churches to a 15-year period. In addition, churches are exempt from unrelated debt-financed income even if the acquired land does not meet the neighborhood test.

Section 514(c)(1) of the Code defines "acquisition indebtedness" as the unpaid amount of indebtedness incurred in acquiring or improving the property.

Section 1.513-1(d)(2) of the Income Tax Regulations ("regulations") provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes; and it is "substantially related" only if the causal relationship is a substantial one. The regulation continues that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 1.514(b)-1(d)(1) of the regulations defines the basic "neighborhood land rule" excepting certain real property from "debt-financed property" if it is acquired for the principal purpose of using it in an exempt function within 10 years (15 years for churches) of the time of acquisition.

Section 1.514(b)-1(d)(1)(i) of the regulations states that if an organization acquires real property for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 10 years of the time of acquisition, such property will not be treated as debt-financed property, so long as (a) such property is in the neighborhood of other property owned by the organization which is used in the performance of its exempt purpose; and (b) the

organization does not abandon its intent to use the land in such a manner within the 10-year period. The rule expressed in this subsection is known as the "neighborhood land rule."

Section 1.514(b)-1(d)(1)(ii) of the regulations states that "[p]roperty shall be considered in the "neighborhood" of property owned and used by the organization in the performance of its exempt purpose if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. If the acquired property is not contiguous with the exempt function property, it may still be in the "neighborhood" of such property, but only if it is within one mile of such property and the facts and circumstances make the acquisition of contiguous property unreasonable."

Section 1.514(b)-1(d)(1)(iii) of the regulations states that "[t]he neighborhood land rule shall not apply to any property after the expiration of 10 years from the date of acquisition. Further, the neighborhood land rule shall apply after the first five years of the 10-year period only if the organization establishes to the satisfaction of the Commissioner that future use of the acquired land is in furtherance of the organization's exempt purpose before the expiration of the 10-year period is reasonably certain. In order to satisfy the Commissioner, the organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue. . . for a ruling at least 90 days before the end of the fifth year after acquisition of the land."

Sections 1.514(b)-1(d)(3)(i), (ii), and (iii) of the regulations state limitations to the neighborhood land rule and correlate to sections 514(b)(3)(C)(i), (ii), and (iii) of the Code.

Section 1.514(b)-1(d)(3)(i) of the regulations states that the neighborhood land rule will apply to land with a structure on it when acquired, or to the land occupied by the structure, only so long as the intended future use of the land requires that the structure be demolished or removed in order to use the land in furtherance of exempt purposes.

Section 1.514(b)-1(d)(3)(ii) of the regulations states that the neighborhood land rule exception to debt-financed property will not apply to structures erected on the land after the acquisition of the land.

Section 1.514(b)-1(d)(3)(iii) of the regulations provides that the neighborhood land rule is inapplicable to property subject to a business lease.

Section 1.514(b)-1(d)(3)(b) *Example (4)* A university acquires a contiguous parcel of land containing an office building intending to demolish the office building and construct a dormitory. Five years later, the dormitory has not been constructed nor has the university satisfied the Commissioner regarding the land's exempt use; university has not received a favorable ruling. In tax year 9 following acquisition of the land, university converts the office building into an administration building used by the university. For years one through five, during which university intends to demolish the existing building, the land is not treated as debt-financed property. In years nine and ten, the land is not treated as debt-financed property because the

University converts the office building to an exempt use (although not the originally intended use). For years six, seven, and eight, the land is debt-financed property and income from the property is subject to tax on unrelated business income.

Section 1.514(b)-1(e)(1) of the regulations provides that "[i]f a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period."

Section 1.514(b)-1(e)(2) of the regulations provides that "this paragraph shall not apply to any property after the expiration of the 15-year period. Further, this paragraph shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year period is reasonably certain. For purposes of the preceding sentence, the rules contained in paragraph (d)(1)(iii) of this section with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply."

Section 1.514(b)-1(e)(4) of the regulations provides that the limitations stated in paragraph (d)(3)(i) and (ii) of this section, regarding demolition or removal of existing structures and subsequent construction of structures on the land, shall similarly apply to the rules contained in this paragraph (regarding churches). The limitation stated in paragraph 1.514(b)-(1)(d)(3)(iii) regarding business leases is not included in section 1.514(b)-1(e) regarding churches.

Analysis:

You are a church classified as tax-exempt under sections 170(b)(1)(A)(i) and 501(c)(3) of the Code. You purchased land on which to build a new, larger church campus on Date 1. You acquired the land subject to acquisition indebtedness. You did not immediately use substantially all of the property for an exempt purpose related to your exempt function. Thus, the land is considered to be debt-financed property according to section 514(b)(1) of the Code.

In general, any income derived from rents or royalties from debt-financed property, as defined by section 514 of the Code, would be treated as unrelated business taxable income under sections 512(a)(1) and (a)(4) of the Code. However, section 514(b)(3) of the Code provides certain exceptions to the general rule. Under that section, when land is acquired for exempt use within 10 years (extended to 15 years for churches), it is not treated as unrelated business taxable income. This exception is commonly referred to as the "neighborhood land rule."

Under the neighborhood land rule, an organization may acquire land adjacent to or within one mile of the organization's present location and convert the land to exempt purpose use within 10 years of acquisition. I.R.C. § 514(b)(3). Any structure on the land when acquired by the organization must be demolished or removed. I.R.C. § 514(b)(3)(C). For churches, section 514(b)(3)(E) of the Code provides special rules. The land must be converted to exempt use within 15 years of acquisition and the neighborhood test of proximity to an existing location is

not applied.

To use the neighborhood land rule, an organization must apply after the first five years and establish to the satisfaction of the Secretary that it is reasonably certain that the land will be used in the manner described in section 514(b)(1)(A) of the Code within the required time period. I.R.C. § 514(b)(3)(A).

As required by section 514(b)(3)(A) of the Code and section 1.514(b)-1(d)(1) of the regulations, you submitted your ruling request in a timely manner, at least 90 days prior to five years after the date of acquisition of the land at issue.

Within the required period, you have taken steps to convert the land to your exempt use. You have demolished structures that existed on the land at the time of acquisition. You have constructed a new church campus of buildings and put it into use for your congregation. You have put your former location up for sale. While the property allows room for future growth, your church campus is substantially complete and converted to exempt use within 15 years of the land acquisition. Thus, your property will not be treated as debt-financed land according to section 514(b)(1) of the Code because you qualify for the exception under the neighborhood land special rule for churches of section 514(b)(3)(E) of the Code.

Since your property is not treated as debt-financed land for 15 years from the date of acquisition, any rents or royalties you receive during that time period will not be treated as unrelated business taxable income under sections 512(a)(1) and 512(b)(4) of the Code. You are not subject, pursuant to section 511, to imposition of tax on unrelated business income for such rents or royalties for the stated period.

Ruling:

1. Based on the information you have submitted, it is reasonably certain that the debt-financed land will be used for an exempt church purpose within 15 years of its acquisition. Therefore, the property is exempt from the debt-financed property unrelated business taxable income provisions of sections 512(b)(4) and 514(b)(1) of the Code as a result of the neighborhood land rule exception of section 514(b)(3)(E) of the Code for 15 years beginning on the date the land was acquired.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolved questions concerning your federal income tax status, this ruling should be kept in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Laurice A. Ghougasian
Acting Manager, Exempt Organizations
Technical Group 4

Enclosure
Notice 437